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No. 103

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1964

UNITED DRAPERIES, INC.,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

The petitioner, United Draperies, Inc. prays that a writ of certiorari be issued to review the judgment of the United States Court of Appeals for the Seventh Circuit in the above case.

OPINIONS BELOW

The opinion of the Tax Court of the United States (A. 24-36)[1] is reported in 41 TC 457. The opinion of the United States Court of Appeals for the Seventh Circuit (App. 1) is reported at 340 F.2d 936.

[1] "A" refers to the Transcript of Record printed for use in the Court of Appeals; "App." to the appendix to this petition.

JURISDICTION

The judgment of the Court of Appeals was entered on December 29, 1964. (App. 7) A motion for rehearing was denied on February 9, 1965. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

During the taxable years petitioner was engaged primarily in the manufacture and sale of draperies for mobile homes. On certain sales petitioner made payments to vice presidents "for purposes of obtaining their employers' business."[2] The Tax Court found "that petitioner's arrangement was advantageous to its enterprise" and that it developed from a small supplier to the "largest supplier of draperies to the mobile home industry." The questions presented are:

1. Whether the amounts paid were an ordinary business expense and, therefore, deductible under Section 162 of the Internal Revenue Code.

2. Whether the Court of Appeals erred in holding that "the end for which an expenditure is made and its utility in achieving the result are *not* the factors which test its ordinariness." (Italics ours)

3. Whether the Court of Appeals erred in holding that the means used to secure and promote business must be an ordinary means in order to be a deductible business expense?

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[2] On all other sales, a sales commission was paid and allowed as an ordinary business expense.

STATUTES AND REGULATIONS INVOLVED

Sec. 162. Trade or Business Expenses.

(a) In General.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Treasury Regulations promulgated under the Internal Revenue Code:

§1.162-1. Business expenses.

(a) In general. Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, except items which are used as the basis for a deduction or a credit under provisions of law other than section 162. The cost of goods purchased for resale, with proper adjustment for opening and closing inventories, is deducted from gross sales in computing gross income. See paragraph (a) of §1.61-3. Among the items included in business expenses are management expenses, commissions (but see section 263 and the regulations thereunder), labor, supplies, incidental repairs, operating expenses of automobiles used in the trade or business, traveling expenses while away from home solely in the pursuit of a trade or business (see §1.162.2), advertising and other selling expenses, together with insurance premiums against fire, storm, theft, accident, or other similar losses in the case of a business, and rental for the use of business property.

STATEMENT OF FACTS.

Petitioner's principal place of business is in Chicago, Illinois. Prior to 1953, petitioner was engaged in manufacturing custom-made draperies and slipcovers for retail consumers. (A. 26)

In 1953, petitioner, for the first time, sold draperies for mobile homes. At this time venetian blinds were the principal covering used for windows in mobile homes. It secured its first order because of Dominic Conte and Donald Bergner, when it sold their company 500 draperies. As part of the sale petitioner agreed to pay 10 percent of the amount collected on the sale to Conte and Bergner. (A. 26) No other sales commission was paid on such sales.

During the years in issue (1957-1960), petitioner was engaged primarily in the manufacture and sale of draperies to mobile homes. Petitioner, at the time of the trial (April, 1963) was the largest supplier of draperies to mobile home manufacturers in the United States. (A. 25)

During the years in question, Dominic Conte was vice president and general manager of Elcar Mobile Homes, located at Bourbon, Indiana; Donald Bergner was vice president and general manager of Kozy Coach Co., located at Kalamazoo, Michigan; and Henry Eckstein was vice president and general manager of M. Systems, Inc., located at Texarkana, Texas. These companies manufactured mobile homes and were subsidiaries of Mid-States Corporation. (A. 25)

Petitioner agreed to supply draperies to these companies and to pay Conte 10 percent of all collections from sales by petitioner to Elcar (later increased to 13 percent)

and 5 percent of all collections from sales to Kozy and M. Systems. Petitioner further agreed to pay Bergner 5 percent of all collections by petitioner from Kozy and to pay Eckstein 5 percent of all collections by petitioner from M. Systems. (A. 26-27)

Pursuant to these agreements, for 1957-1960 petitioner paid the vice presidents a total of $138,424 in cash. (A. 28) It also made gifts (such as suits, automobiles, etc.) to them in the amount of $21,433. (A. 29)

The amounts were paid by check and reported on information returns filed with the Treasury Department. (Ex. 6F, 7G, 8H, 9I, 10J, 18, 19, 20, 21, 25, 26, 27, 28, 29) The recipients paid their income tax on the payments received.

There was no addition to the price charged by petitioner because of these payments. (Trans. p. 53)

Petitioner made the payments to the vice presidents for the purpose of obtaining their employers' business. (A. 30, 31)

In addition, the vice presidents assisted petitioner by specifying the measurement, material and design to be used in the draperies for their mobile homes. In 1959, Conte made a written guaranty of prompt payment of taxpayer's bills. Rosenberg, petitioner's president, also went with Conte to several mobile home shows where Conte introduced him to other mobile home manufacturers. Conte also accompanied Rosenberg on several trips to New York to buy material. (A. 27)

With the exception of the payments at issue in this case, there were no commissions paid by petitioner on the sales to these customers. Petitioner paid to an employee a 7% commission on all other sales. (A. 29) This commission was allowed as an ordinary business expense.

There was no determination by the Federal Trade Commission that petitioner violated its regulations. Nor was there a determination by the courts of the State of Michigan that a Michigan law was violated. (Trans. p. 61)

The Tax Court held that the rebates and gifts were not deductions, but gave no reason for the disallowance. (A. 8, 20)

The District Director of Internal Revenue disallowed the deductible because all were in violation of Section 3.310 of the Federal Trade Commission regulations and, in addition, those payments to Bergner that were sent by mail were in violation of Section 28.320 of the Michigan statutes. It also held the payments were not deductible because they were not ordinary and were not necessary.

During the oral argument before the Court of Appeals, counsel for the government stated that the government was abandoning its reliance on the public policy doctrine for the disallowance of these expenditures.

The majority of the Court of Appeals affirmed the Tax Court's decision on the ground that the payments were not ordinary. It held that the Tax Court's findings that the payments were made for the purpose of obtaining business and that by virtue of these payments taxpayer gained a substantial volume of sales and became the country's largest manufacturer of draperies for mobile homes were *not* factors which show that the payments were ordinary business expenses. It held that these payments were not deductible as business expenses because they were not "an ordinary means of securing or promoting business."

Circuit Judge Knoch in a short dissenting opinion stated:

> "The immorality and the unethical character of the procedure followed by the taxpayer with such success is appreciated. However, in the light of the statement of the Commissioner, that:

> 'In this case, the taxpayer by the payment of kickbacks to employees, entered a special market, gained a substantial volume of sales, and became the country's largest manufacturer of draperies for mobile homes.'

and, the opinion of the Tax Court that these amounts were:

> '. . . paid by petitioner (taxpayer) to Conte, Eckstein and Bergner for the purpose of obtaining their employers' business . . .'

and, further, that:

> 'There is no question that petitioner's arrangement with Conte, Eckstein, and Bergner was advantageous to its enterprise. Subsequent to this arrangement, petitioner developed from a small supplier of custom-made draperies for retail buyers with gross sales in 1954 of $123,239.41 to the largest supplier of draperies to the mobile home industry with gross sales in 1960 of $437,761.93.'

it is my view that these payments were ordinary and necessary expenses incurred in the taxpayer's business within the meaning of the applicable regulations.

"I believe that the methods used by the taxpayer in the instant case should be prohibited, but that this beneficent result should be attained by Congressional action and not by court edict."

REASONS FOR GRANTING THE WRIT

A. The decision of the Court of Appeals is in conflict with decisions of this Court and decisions of other Courts of Appeals.

B. The Court below erroneously determined a question of national importance in the applications of the Internal Revenue Code relating to the deduction of business expenses.

Under Section 162(a) a taxpayer may deduct "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."

The Court of Appeals did not dispute that the payments to the executives of its customers were incurred in carrying on a trade or business. Nor did it dispute that the payments were made for the purpose of obtaining business and by virtue of these payments taxpayer entered a special market, gained a substantial volume of sales and became the country's largest manufacturer of draperies for mobile homes. Nevertheless, the Court disapproved the deduction on the ground that "the end for which an expenditure is made and its utility in achieving the result are not the factors which test its ordinariness."

It held that these payments were not deductible as business expenses because they were not "an ordinary means of securing or promoting business." It held this despite the fact a 7% sales commission was paid on all other sales. Thus, the holding below results in no allowable sales commission on the sales in question.

In placing the test on the means and in ignoring absolutely the end and the result of the expenditure, the Court of Appeals has abandoned over fifty years of administra-

tion and construction of a provision in the tax law which vitally affects every business enterprise.

In fifty years of income tax law, no Court of Appeals (where the public policy issue was not present) has denied the deductibility of "kickbacks" because they were not ordinary. Although arising from different facts, the decision of the Court below is in conflict with the decision of this Court in *Lilly* v. *Commissioner*, 1952, 343 U.S. 90, the decision of the Court of Claims in *Paramount Finance Co.* v. *United States*, 1962, 304 F. 2d 460; the decision of the Fourth Circuit in *Richardson* v. *Commissioner*, 1959, 264 F. 2d 400; and the decision of the Third Circuit in *Valetti* v. *Commissioner*, 1958, 260 F. 2d 185, in which cases "kickbacks" have been allowed as an ordinary and necessary business expense.

In *Lilly*, the payments were made in the optical business, in *Paramount Finance Co.*, the payments were made in the insurance business, and in *Richardson* and *Valetti*, the payments were made in the ship repair business. Here, the payments were made in the drapery business.

The Court of Appeals has attempted to distinguish *Lilly* by stating that the record in *Lilly* revealed a widespread practice in the industry of making payments of that character. It is submitted that this was not the determining factor in allowing the deductibility of those payments and that the Court of Appeals has misconstrued *Lilly*.

In *Deputy* v. *DuPont*, 308 U.S. 488, the Court said:

> "To be sure, an expense may be ordinary, though it may happen once in a taxpayer's lifetime."

In any event, there was no showing in *Paramount Finance Co.* v. *United States*, 1962, 304 F. 2d 460, that such payments were common in the insurance business, but the

Court of Claims held them to be an ordinary business expense.

Surely, malpractice, fraud, breach of fiduciary duty, negligence or conspiracy are not wide-spread in industry. Nevertheless, the courts have repeatedly held that damages paid because of a wrong committed in the operation of a business are deductible as ordinary and necessary expenses.[3]

Welch v. *Helvering*, 290 US 111, relied upon by the Court below, is not in point because it involved payments made to discharge debts of an adjudicated bankrupt. This Court held that payment made under such circumstances, instead of being ordinary, was in a high degree extraordinary. It held that the payments were closer to outlays of a capital nature than to ordinary and necessary expenses in the operation of a business. The opposite is true here—these payments replaced sales commissions paid on all other sales.

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[3] *Ditmars* v. *Commissioner*, 1962, 2 Cir., 302 F. 2d 481 (settlement made by broker in satisfaction of claim for "churning" and other acts to defraud the trust remainderman); *James E. Caldwell & Co.* v. *Commissioner*, 1956, 6 Cir., 234 F. 2d 660 (milking and dissipating corporate assets by conspiracy and fraud); *Becker Bros.* v. *United States*, 1925, 2 Cir., 7 F. 2d 3 (infringement of a patent); *Helvering* v. *Hampton*, 1935, 9 Cir., 79 F. 2d 358 (fraud); *Anderson* v. *Commissioner*, 1936, 10 Cir., 81 F. 2d 459 (negligence resulting in death); *H. M. Howard*, 22 BTA 375 1931 (misrepresentation and conspiracy); *W. R. Hervey*, 25 BTA 1282, 1932 (violation of usury laws); *International Shoe Co.*, 38 BTA 81, 1938, (unfair competition including conspiracy to destroy a creditor); *Robert S. Farrell*, 44 BTA 238, 1941 (unlawful acts as a director); *William Ziegler, Jr.*, 5 TC 150, 1945 (mismanagement of corporation); *Dixon Fagerberg*, P-H BTA Memo Dec. Para. 42,091 (conversion of corporate assets); *Cornelius Vanderbilt, Jr.*, 16 TCM 1081, 1957 (libel); *Clark*, 30 TC 1330, 1958 (assault).

The income tax is a levy on business net income. Generally, all the expenses incurred in a trade or business are deductible, unless the expenditure is a capital expenditure or entirely unrelated to the business. This has been the basic policy of the tax law since the enactment of the 1913 income tax act. The Court of Appeals decision is not in accord with this basic policy. It does not allow an expense which has produced the income being taxed.

The result of the decision below is that for the fiscal year 1957, taxpayer paid an income tax of $27,438.97 when it had commercial net income of $19,592.43. For the fiscal year 1958, taxpayer paid an income tax of $41,644.78 when it had a commercial net income of $36,349.03.

The statute does not attempt to regulate or improve trade practices and customs as they are reflected in the operating costs of a business. It purports to raise revenue. It does not seek to encourage virtue and discourage sin.

In *Commissioner* v. *Heininger,* 320 U.S. 467, 474, this Court stated:

> "The language of Section 23(a) contains no express reference to the lawful or unlawful character of the business expenses which are declared to be deductible. And the brief of the government in the instant case expressly disclaims any contention that the purpose of tax laws is to penalize illegal business by taxing gross instead of net income."

In *Commissioner* v. *Sullivan,* 356 U.S. 27, 29, this Court said:

> "If we enforce as federal policy the rule espoused by the Commissioner in this case, we would come close to making this type of business taxable on the basis of its gross receipts, while all other business would be taxable on the basis of net income. If that choice is to be made, Congress should do it."

In Rev. Rul. 64-224, dated August 17, 1964, the Commissioner of Internal Revenue ruled that payments made by the electrical equipment makers to the utilities because of the infamous "Price-Fixing Conspiracy" are deductible as ordinary and necessary business expenses.

As this Court is aware, 29 companies were involved in that conspiracy. Included were some of the best-known companies in the country. The executives involved were of the highest echelon.

Eighteen of the corporate defendants pleaded guilty. Seven of the executives went to jail. Fines totalling nearly $2,000,000.00 were set.

Afterwards, the electric utilities instituted nearly 2,000 suits for damages. One of the companies, General Electric, has paid some $173,000,000.00 in out-of-court payments to date. It is the payments made by virtue of these suits that the Commissioner of Internal Revenue by administrative action has ruled to be deductible as an ordinary and necessary business expense.

It is hard for us to distinguish why General Electric is entitled to deduct $173,000,000 as an ordinary and necessary business expense, while United Draperies cannot deduct $138,000 as an ordinary and necessary expense. Perhaps the fact that 29 companies in the industry were involved in the great "Price-Fixing Conspiracy" makes the payments ordinary.

It is obvious that the life-blood of a business is sales. Without sales, no business can exist. It would appear that payments to obtain business as a class are always ordinary and necessary business expenses.

The Treasury Regulations recognize this (as the dissenting judge points out) when they set forth as business expenses "commissions . . . advertising and other selling

expenses." To say, therefore, that a nonconventional expenditure incurred in selling or advertising is not deductible is contrary to the words of the regulations which specifically allow the deduction of all advertising and other selling expenses. These words have been in the regulations since 1921. Here, as in *Textile Mills Corp.* v. *Commissioner*, 314 U.S. 326, we have the benefit of an interpretative departmental regulation defining the application of the words "ordinary and necessary" to the particular type (selling) of expense here involved.

The decision of the Court below on the interpretation to be given to the word "ordinary" in Section 162 cannot possibly be reconciled with the decisions of this Court and the other Courts of Appeal. The rationale of the decision of the majority in the Court below is that the test of "ordinary" is that the means must be ordinary and that the end and utility of an expenditure are not factors which test its ordinariness. This rationale is in irreconcilable conflict with the interpretation of "ordinary" in Section 162 adopted by the Eighth Circuit in *Poletti* v. *Commissioner*, 1964, 330 F. 2d 818.

In the *Poletti* case, taxpayer, who operated employment agencies, engaged in a program of gifts to job applicants, employers whose patronage afforded job placements of applicants, and taxpayers own employees on special occasions. The government's proof "consisted in chief of the testimony of two of taxpayer's competitors who stated they did not utilize the 'give-away' type of promotion, nor was it customary among other employment agencies in the St. Louis area. The Court of Appeals held these expenses to be ordinary business expenses, stating (p. 822):

> "While success of a business promotion scheme is not a conclusive test of ordinary and necessary business expense, on the other hand, one should not be penalized taxwise for his business ingenuity in utilizing

advertising techniques which do not conform to the practices of one whom he is naturally trying to surpass in profits. It would be a hard rule, not in keeping with our free enterprise system, which in effect forbade a businessman from employing non-conventional advertising methods because resultant expenses were non-deductible. Certainly, Congress did not intend § 162(a) to have the effect of confirming business advertising and promotion to the stereotyped pattern that might be set by unimaginative competitors in the taxpayer's business locale."

The uniform construction heretofore given to the statute is that where, as here, payments are made to promote a taxpayer's business they are an ordinary and necessary business expense. A list of some of the many cases with this holding are set forth in Appendix C to this petition. It should be pointed out that the means used in these cases generally were not, what might be called, an ordinary means of promoting business. Yet the mere fact that the purpose of the expenditures was to promote the business made them "ordinary and necessary."[4] Thus, the effect of the court's decision is to unsettle an area of the tax law which had acquired stability. This decision will increase uncertainty and litigation as to the deductibility of every business expense. Every business enterprise is affected.

The rule that the means of securing or promoting business must be ordinary and that the purpose and utility of the expenditure is not to be considered is unsound in

[4] We are not contending for a rule which would make illegal means to a legal end, "ordinary and necessary." But as the Court has stated this issue is not in the case because in open court during the oral argument counsel for the government stated that the government was abandoning its reliance on the public policy doctrine for the disallowance of these expenditures.

that it is difficult to administer and makes the tax law uncertain. Thus, it violates important elements of any sound tax law.

Are the expenses of the Fuller Brush Co. in selling door to door deductible when it is the only brush company which uses this means of selling?

Where only one food market chain uses trading stamps, can it be said that this is an ordinary means of securing business so the expense is deductible?

Is television advertising an ordinary means of securing business and, therefore, deductible when only U. S. Steel in the steel industry has television programs?

Where the Goodyear Company is the only company which uses a blimp for advertising purposes, should it be allowed its cost as an advertising expense?

In so far as Section 162 is concerned, the basic policy of Congress is beyond dispute. That provision was not imposed in order to create or enforce a code of business or professional ethics. Nor was it imposed in order to tell the businessman how he should run his business. Certainly there is no indication that respondent's agents are particularly skilled in the art of operating a business as distinguished from the art of computing and collecting taxes. The sole objective of Section 162 is to confine the burden of the income tax to net income. "The purpose here is to tax earnings and profits less expenses and losses." *Higgins* v. *Smith*, 308 U.S. 473, 476-477 (1940). "Taxation on net, nor on gross income has always been the broad basic policy of our income tax laws." *Black J., McDonald* v. *Commissioner*, 323 U.S. 57, 66-67.

CONCLUSION.

The decision below presents the strongest possible reasons for review by this Court. Taxpayers in the Seventh Circuit cannot deduct these payments while all other taxpayers can. Only this Court can see that citizens of Illinois, Wisconsin and Indiana are treated the same as the citizens of the various other states.

For the foregoing reasons, this petition for certiorari should be granted.

Respectfully submitted,

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APPENDIX A

In the

United States Court of Appeals

For the Seventh Circuit

SEPTEMBER TERM, 1964 — SEPTEMBER SESSION, 1964

Nos. 14630 - 14631
UNITED DRAPERIES, INC., *Petitioner,*
vs.
COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

Petition for Review of Decisions of the Tax Court of the United States.

DECEMBER 29, 1964

Before HASTINGS, *Chief Judge,* and KNOCH and CASTLE, *Circuit Judges.*

CASTLE, *Circuit Judge.* These petitions for review of Tax Court decisions concern income tax deficiencies determined against petitioner as the result of the disallowance of certain deductions claimed for the taxable years involved[1] as commission expenses and sales promotion ex-

[1] No. 14630 concerns the deficiencies determined for the taxpayer's fiscal years ended March 31, 1957; March 31, 1958 and March 31, 1959. No. 14631 concerns the deficiencies determined for the taxable period April 1, 1959 to December 31, 1959, and for the taxable year ended December 31, 1960.

penses paid and incurred by the petitioner in carrying on its business. The claimed commission expenses disallowed total $138,423.61, and the claimed sales promotion expenses disallowed total $21,432.55.

During the years in issue (1957-1960), petitioner was engaged primarily in the manufacture and sale of draperies to manufacturers of mobile homes. Prior to 1953, petitioner had manufactured custom-made draperies and slip-covers for retail consumers. At that time venetian blinds were the principal covering used for windows in mobile homes. Petitioner secured an order for draperies for such purpose in 1953 from Mid-States Corporation. It paid ten percent of the amount collected on the order to Dominic Conte and Donald Bergner. Conte was then assistant purchasing manager for Mid-States and Bergner was an employee of Mid-States.

Mid-States was engaged in the manufacture of mobile homes through controlled subsidiary corporations including Elcar Mobile Homes, Inc.; M. Systems, Inc.; and Kozy Coach Company. During the years in issue Conte was vice-president and general manager of Elcar. Henry Eckstein and Donald Bergner occupied such office and position with M. Systems and Kozy Coach, respectively. Petitioner supplied draperies to these companies and pursuant to a side agreement with Conte paid Conte ten percent (increased to thirteen percent for the latter portion of the period) of all collections from sales by petitioner to Elcar and five percent of all collections from sales to Kozy Coach and M. Systems. Under the agreement it paid Bergner five percent of all collections from Kozy Coach, and Eckstein five percent of all collections from M. Systems, The disallowed $138,423.61 represents such payments.

The disallowed $21,432.55 represents gifts of cash, suits, furniture and automobiles petitioner made to the three vice presidents-general managers of the above customer corporations.

The Tax Court found and concluded[2] that the expenditures involved were not ordinary and necessary business expenses of the petitioner nor excludable from its gross income.

The contested issues presented for our determination by the contentions advanced in this Court[3] are whether the Tax Court applied correct legal criteria (1) in concluding that the payments of money and gifts of property disallowed as deductions did not constitute "ordinary and necessary" business expenses deductible from gross income under Section 162(a) of the Internal Revenue Code of 1954,[4] and (2) in concluding that the payments were not excludable from gross income.

The Tax Court characterized the payments as "amounts paid by petitioner to Conte, Eckstein, and Bergner for the purpose of obtaining their employers' business". It found that the arrangement was advantageous to the petitioner's enterprise, observing that subsequent thereto the petitioner developed from a small supplier of custom-made draperies for retail buyers to the largest supplier of draperies to the mobile home industry. But it concluded that

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[2] 41 T.C. 457

[3] In the Tax Court petitioner contended that the percentage payments represented compensation in return for personal services rendered to it by the recipients. The Tax Court's finding and conclusion to the contrary is not assailed on review. Moreover, we perceive no error in this connection.

[4] 26 U.S.C.A. §162(a).

the petitioner failed to establish that the payments and gifts were "ordinary" and "necessary" business expenses within the sense of those terms as employed in Section 162(a).

Apart from the question of whether the record fails to establish that the expenditures involved were necessary to obtain or retain the business of the three customers involved we are of the opinion that the Tax Court did not err in concluding that the gifts and "kick-backs" were not ordinary business expenses within the rationale of *Welch* v. *Helvering,* 290 U.S. 111 and *Deputy* v. *du Pont,* 308 U.S. 488. *Lilly* v. *Commissioner,* 343 U.S. 90, one of the cases relied upon by the petitioner, is not apposite here. The record in *Lilly* revealed a widespread practice in the optical industry of making payments of the character there involved. In the instant case the practice was confined to the three subsidiaries of Mid-States. There is nothing to show that the practice was a normal incident to the drapery manufacturing industry or to suppliers of mobile home manufacturers generally. No such expenditures were made in connection with the nine other mobile home manufacturer customers of the petitioner—and the accounted for approximately fifty percent of the petitioner's business.

Petitioner urges, in effect, that payments made to obtain business if of a nature helpful and appropriate to that end are as a class always ordinary and necessary business expenses. But the end for which an expenditure is made and its utility in achieving the result are not the factors which test its ordinariness. As a matter of common knowledge we are convinced that the mores of the market place of this nation is not such that "kick-backs" by vendor-suppliers to the officers or employees of customers, while they do occur, are an ordinary means of secur-

ing or promoting business. And the record reveals nothing inherent in the nature of petitioner's drapery enterprise which serves to endow such payments with a character of ordinariness they would not otherwise possess. In reaching this conclusion we do so apart from consideration of the morality or legality of the practice. Cf. *Heininger* v. *Commissioner,* 320 U.S. 467, 474; *Sullivan* v. *Commissioner,* 7 Cir., 241 F. 2d 46; *Commissioner* v. *Doyle,* 7 Cir., 231 F. 2d 635. We merely point out that we agree with the Tax Court that it requires more of a showing than was made by the petitioner to establish that such a practice constitutes an "ordinary" business expense in the circumstances here presented.

We perceive no merit to the petitioner's contention that the Tax Court erred in concluding the expenditures were not excludable from gross income. The payments and gifts were not rebates to the customer which in effect reduced the purchase price received by the petitioner. Nor were the recipients merely conduits through whose hands the money passed—they received the payments as their own—pursuant to the petitioner's agreements with Conte. And the payments received by the petitioner from the purchasing corporations were not received without a claim of right to the entire amount as was the case in *Lashells' Estate* v. *Commissioner,* 6 Cir., 208 F. 2d 430.

The decisions of the Tax Court are affirmed.

AFFIRMED

KNOCH, *Circuit Judge,* dissenting. The immorality and the unethical character of the procedure followed by the taxpayer with such success is appreciated. However, in the light of the statement of the Commissioner, that:

> [I]n this case, the taxpayer, by the payment of kickbacks to employees, entered a special market, gained

> a substantial volume of sales, and became the country's largest manufacturer of draperies for mobile homes.

and the opinion of the Tax Court that these amounts were:

> * * * paid by petitioner [taxpayer] to Conte, Eckstein and Bergner for the purpose of obtaining their employers' business * * *

and, further, that:

> There is no question that petitioner's arrangement with Conte, Eckstein, and Bergner was advantageous to its enterprise. Subsequent to this arrangement, petitioner developed from a small supplier of custom-made draperies for retail buyers with gross sales in 1954 of $123,239.41 to the largest supplier of draperies to the mobile home industry with gross sales in 1960 of $437,761.93.

it is my view that these payments were ordinary and necessary expenses incurred in the taxpayer's business within the meaning of the applicable regulations.

I believe that the methods used by the taxpayer in the instant case should be prohibited, but that this beneficent result should be attained by Congressional action and not by court edict.

A true Copy:

Teste:

.....

Clerk of the United States Court of Appeals for the Seventh Circuit.

APPENDIX B.

In the

United States Court of Appeals

For the Seventh Circuit

Tuesday, December 29, 1964

Before

HON. JOHN S. HASTINGS, *Chief Judge*
HON. WIN G. KNOCH, *Circuit Judge*
HON. LATHAM CASTLE, *Circuit Judge*

Nos. 14630 - 14631
UNITED DRAPERIES, INC.,
Petitioner,
vs.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Petition for Review of Decision of the Tax Court of the United States.

This cause came on to be heard on the transcript of the record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this Court that the decisions of the Tax Court of the United States entered in this cause on February 17, 1964, Tax Court Docket Nos. 94171 and 3952-62, be, and the same are hereby, AFFIRMED, in accordance with the opinion of this Court filed this day.

APPENDIX B

In the

United States Court of Appeals

For the Seventh Circuit

Chicago, Illinois, 60610

Tuesday, February 9, 1965

Before

HON. JOHN S. HASTINGS, *Chief Judge*
HON. WIN G. KNOCH, *Circuit Judge*
HON. LATHAM CASTLE, *Circuit Judge*

Nos. 14630 - 14631
UNITED DRAPERIES, INC.,
Petitioner,
vs.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Petition for Review of Decision of the Tax Court of the United States.

IT IS ORDERED by the Court that the petition for a rehearing of this cause filed by petitioner herein be, and the same is hereby DENIED.

(Judge Knoch voted to grant petition for rehearing).

APPENDIX C.

List of Some of the Cases Holding That Where Payments Are Made To Promote A Taxpayer's Business They Are An Ordinary and Necessary Business Expense

Dunn & McCarthy, Inc. v. *Commissioner,* 2 Cir., 139 F. 2d 242, where the Court pointed out (p. 244) "the outlay was made for the *purpose* of conserving the goodwill of salesmen and of customers and actually accomplished that purpose."

Helvering v. *Community Bond & Mortgage Corporation,* 2 Cir., 74 F. 2d 727, where the court observed (p. 728), "In *Welch* . . . the payments were made for the purpose of establishing the taxpayer's goodwill and were therefore a capital outlay. . . . In the instant case, the . . . motive . . . was to prevent the loss of earnings. . . . This we think was an expenditure ordinary and necessary in carrying on the business, and deductible from the respondent's gross income."

Edward J. Miller, 38 BTA 830, where the Board observed, "it is well settled that expenditures made to protect or to promote a taxpayer's business, and which do not result in the acquisition of a capital asset, are deductible."

Scruggs-Vandervoort-Barney, Inc., 7 TC 779, the court held a department store entitled to deduct payments made to customers of a bank located in the store to make good their losses upon failure of the bank. The court observed that the payments "were made to protect and promote petitioner's business" and were, therefore allowable.

The First National Bank of Skowhegan (1937), 35 BTA 876, where the Board observed (p. 884) "This Board and the courts have repeatedly allowed deductions where

the disbursement was made to protect or promote the taxpayer's business."

Margaret J. Reis (Tax Court, Feb. 6, 1941) CCH Dec. 11,648-G, 10 P-H Memo Dec. 41-194, where the court said sums paid "to protect one's business and goodwill . . . (are) deductible as business expense."

Boulevard Frocks, Inc. (Tax Court, Jan. 2, 1943), CCH Dec. 12,930-A, P-H Memo Dec. 43-19, where the court said "the courts and the Board of Tax Appeals have allowed the deduction of sums spent to preserve, protect and promote the taxpayer's business, as ordinary and necessary expenses of carrying on that business."

A. D. Miller, 1951 TC Memo, where the court allowed cost of Christmas party for children by tavern owner to promote good will with their parents.

Cubbedge Snow, 31 TC 585, where the Tax Court allowed a deduction to lawyers for payments made to make good an operating deficit of a savings and loan association. The court observed, "It is well established that reasonable 'expenditures made to protect or to promo e a taxpayer's business, and which do not result in the acquisition of a capital asset, are deductible' as ordinary and necessary expenses of transacting a trade or business. . . . The crucial and controlling factor lies in determining whether the acts done and expenditures made were motivated by a purpose to protect or to promote the taxpayer's business or were made as an investment in a new enterprise."

Maurice E. Harvey, 1953 TC Memo, where the court allowed a deduction to a salesman who gave samples of whiskey to his customers.

Blackmer v. *Commissioner*, 2 Cir., 70 F. 2d 255, a professional actor who furthered his career by bestowing gifts and extensive entertainment was allowed the deduction. The Court stated (p. 257): "His entertainment was reasonably connected with his profession. It tended to promote his popularity and thereby increase his income from that business. The expenses were therefore ordinary and necessary."

Sanitary Farm Dairy, Inc., 25 TC 463, where the Tax Court allowed the cost of big game hunt intended for advertising purposes.

F. L. Bateman, 34 BTA 351, where the court allowed the deduction of tips paid to railroad employees to expedite taxpayers' shipments.

Mara Bros., 3 TCM 1317, where the Tax Court allowed the deduction of tips given to ships officers for favors.

L. Heller & Son, Inc., 12 TC 1109, where the court allowed petitioner's payments of debts of a subsidiary which had undergone a 77B reorganization. It said the payments were "calculated to protect and promote petitioner's business . . . as such, they are deductible in any event as ordinary and necessary business expense."

Catholic News Publishing Co., 10 TC 73, where the corporation paid an amount to its president to reimburse him for a payment in settlement of a dispute with trade association of which he was treasurer over his handling of association funds, the corporation having told him to settle as the controversy was injuring its business. The court said that "as the payment in question was proximately related to the conduct of the petitioner's business . . . and was made to protect and promote that business . . . it is our opinion that it constitutes an ordinary and necessary business expense."

B. Manischewitz Co., 10 TC 1139, where payments to foreign religious seminary by producer of religious dietary article allowed as "ordinary and necessary" where there are "business ends to be served and the intention to serve them appears adequately from the record."

Rodgers Dairy Co., 14 TC 66, where maintenance expenses of show horses and dogs were deductible where the animals were acquired and used to advertise restaurant chains.

Hennepin Holding Co., 23 BTA 119, where landlord's payments to advertise and rehabilitate tenant's business to assure continuance of favorable rental income was allowed.

Shasta Water Co., 1942 TC Memo, where mineral water bottler paid losses of subsidiary that operated resort hotel as part of publicity program. The amounts paid were allowed.

In the Supreme Court of the United States

OCTOBER TERM, 1965

No. 103

UNITED DRAPERIES, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

During the taxable years in issue (April 1, 1956 to December 31, 1960) petitioner was engaged in the production and sale of draperies to manufacturers of mobile homes. Among petitioner's customers were Mid-States Corporation and its subsidiaries. Pursuant to a side agreement, petitioner paid three officers of Mid-States or its subsidiaries specified percentages (ranging up to 13%) of sales by petitioner to Mid-States and its subsidiaries. The Commissioner disallowed $138,423.61 of such payments deducted by

petitioner. In addition, the Commissioner disallowed $21,432.55 constituting gifts of cash, suits, furniture and automobiles by petitioner to the three officers (Pet. App. 1-3).

The Tax Court held that these payments were not deductible expenses within § 162 of the Internal Revenue Code of 1954 for three separate reasons. First, the Tax Court found that the payments frustrated sharply defined national or State policy (R. 33-35).[1] It cited the Federal Trade Commission regulation prohibiting a supplier from "Secretly giving . . . employees of customers . . ., without knowledge or consent of their employers, as inducement to purchase products . . ., money or anything of value . . ." (16 C.F.R. 3.310 (1949 ed.)). Since some of the payments were mailed into Michigan, the court also cited a Michigan criminal statute prohibiting any person from giving ". . . an agent . . . of another . . . any commission, gift or gratuity . . . with intent to influence the action of such agent . . . in relation to his principal's . . . business . . ." (Michigan Stat. Ann., § 28.320).

Second, the Tax Court held that the payments were not "ordinary" since there was no evidence that such payments were commonly made in petitioner's industry (R. 32). In fact, petitioner's president testified that it made no such payments to the employees of any of its other customers (R. 32).

Third, the Tax Court found that the payments were not "necessary," since there was no evidence that peti-

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[1] "R" references are to the petitioner's printed appendix in the court of appeals.

tioner would not have gotten the business without the payments (R. 32-33).

The court of appeals affirmed on the ground that the "kickbacks" were not ordinary because "there is nothing to show that the practice was a normal incident to the drapery manufacturing industry or to suppliers of mobile home manufacturers generally." (Pet. App. 4-5)[2] The court of appeals did not discuss the other two grounds relied upon by the Tax Court (Pet. App. 1-5).[3]

In *Tank Truck Rentals* v. *Commissioner*, 356 U.S. 30, 33-34, this Court held that expenditures which "frustrate sharply defined national or state policies proscribing particular types of conduct, evidenced by some governmental declaration thereof" are not deductible. The Court stated that "the test of nondeductibility always is the severity and immediacy of the frustration resulting from allowance of the deduction" (*id.* at 35). And the Court concluded: "Certainly the frustration of state policy is most complete and direct when the expenditure for which deduction is sought is itself prohibited by statute" (*ibid*). In the instant case petitioner's payment of

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[2] Both lower courts also correctly determined that the kickbacks were not excludable from petitioner's gross income as rebates to customers (Pet. App. 5, R. 35). Petitioner has not raised this issue in his petition.

[3] There is no basis in fact for petitioner's assertion that the government abandoned its reliance on the public policy doctrine in the court of appeals (Pet. 6, 14 n. 4). Government counsel orally stated to the court of appeals that it could decide this case on the ground that the kickbacks were not "ordinary" expenses without reaching the public policy issue.

the kickbacks constituted a violation of long-standing FTC regulations and, as to those kickbacks mailed into Michigan, a violation of that State's criminal statutes. The very payments here disallowed are thus themselves a violation of "sharply defined . . . policies . . . evidenced by [a clear] . . . governmental declaration". To permit a deduction for such kickbacks would "frustrate" public policy even more than granting a deduction for fines and penalties levied as punishment for violating the law. See *Tank Truck Rentals* v. *Commissioner*, *supra*.[4]

Moreover, this Court, in *Deputy* v. *DuPont*, 308 U.S. 488, 495, stated that while "an expense may be ordinary though it happen but once in the taxpayer's lifetime . . . [y]et the transaction which gives rise to it must be of common or frequent occurrence in the type of business involved." And in *Lilly* v. *Comissioner*, 343 U.S. 90, the Court required proof of a "long-established practice in the optical industry in the localities where petitioners did business" before it would permit a deduction for kickbacks from optical companies to prescribing doctors (at 93). Here the evidence showed that the payment of kickbacks was not a practice in either the industry or the localities

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[4] Because the expenditures here are themselves prohibited and thus their deductibility would constitute the severest and most immediate type of frustration of sharply defined public policy, we believe that the Seventh Circuit's decision should be permitted to stand regardless of this Court's action in *Commissioner* v. *Tellier*, No. 351, Oct. Term, 1965, pending on petition for certiorari, involving the deductibility of legal expenses incurred in the unsuccessful defense of a business-related criminal prosecution.

where petitioner did business and that the transactions giving rise to petitioner's claimed deductions were not of common or frequent occurrence in the type of business involved. The kickbacks were thus not "ordinary" within the meaning of Code Section 162.

The cases cited by petitioner involve factual situations widely variant from the instant case, and thus they are not in conflict with the present decision.

For these reasons the petition for a writ of certiorari should be denied.

Respectfully submitted,

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Solicitor General.

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Assistant Attorney General.

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FRED E. YOUNGMAN,
Attorneys.

JULY, 1965

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No. 103

IN THE

Supreme Court of the United States

OCTOBER TERM, 1965

UNITED DRAPERIES, INC.,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

REPLY TO MEMORANDUM IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1965

No. 103

UNITED DRAPERIES, INC.,

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COMMISSIONER OF INTERNAL REVENUE,

Respondent.

REPLY TO MEMORANDUM IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

Since petitioner filed its petition for certiorari in this case the government has petitioned for certiorari in *Commissioner* v. *Tellier*, No. 351, Oct. Term, 1965.

The question as stated by the Commissioner in its petition in the *Tellier* case is whether certain legal expenses incurred in an unsuccessful defense for violation of the Securities Act and the mail fraud statute "are deductible as ordinary and necessary business expenses under Section 162(a)". The issue in the instant case is whether the payment of kickbacks are deductible as ordinary and necessary business expenses under Section 162(a).

In *Tellier* the Second Circuit said, "yes". In the instant case the Seventh Circuit said, "no".

In respondent's memorandum in opposition, the Commissioner states "that the Seventh Circuit's decision should be permitted to stand regardless of this Court's action in *Commissioner* v. *Tellier*, No. 351, Oct. Term 1965, pending on petition for certiorari because the expenditures here" are against public policy.

We point out that the majority opinion of the Court below stated:

> "In reaching this conclusion we do so apart from consideration of the morality or legality of the practice. Cf. *Heininger* v. *Commissioner*, 320 U.S. 467, 474; *Sullivan* v. *Commissioner*, 7 Cir. 241 F.2d 46; *Commissioner* v. *Doyle*, 7 Cir., 231 F.2d 635."[1]

The dissenting judge in the Court below would allow the deduction in spite of the morality or legality of the practice and would leave it to "Congressional action and not by court edict" to disallow these expenditures.

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[1] In spite of respondent's denial (footnote 3) (after checking with persons who were present) we repeat that during the oral argument before the Court of Appeals counsel for the government stated that the government was abandoning its reliance on the public policy doctrine for the disallowance of these expenditures. If this point is deemed crucial it is requested that the panel of judges of the Seventh Circuit who heard the case below (particularly Judge Hastings in response to whose question counsel stated that the public policy argument was being abandoned) be queried.

Despite the Commissioner's attempt to distinguish this case from *Tellier* on grounds not considered by the Court below (because it was abandoned by the Commissioner), it is submitted that the case of *Tellier* v. *Commissioner*, 2 Cir., ... F.2d ..... is in conflict with this case and, therefore, request for a writ of certiorari should be granted in both cases.

Respectfully submitted,

HAROLD R. BURNSTEIN,
JOHN W. HUGHES,
GEORGE BRODE,
Attorneys for Petitioner

END